

The Business of Insurgency:

The Expansion of Iraq's Shadow Economy

—Robert Looney

MEDIA ATTENTION on the insurgency in Iraq has tended to focus on dramatic incidents or horrific acts of violence. At the same time, policymakers in the U.S. and other coalition countries have often viewed the insurgency in largely political terms. Yet particularly worrisome is the convergence of large segments of the Iraqi insurgency with elements of organized crime. Unfortunately, improved anti-terrorism effectiveness has resulted in increased resort to criminal activity among several significant groups within the insurgency.

So while the political and military aspects of the insurgency have received most of the world's attention the insurgency's subtle shift towards increased reliance on criminal activity has just as important implications for the Iraqi economy. Increased criminal activity is effectively stifling attempts to expand the formal sector. This, in turn, presents a major challenge to the newly elected government—how to stop and reverse the insurgent-led deterioration of the economy and the vicious cycle it has created. It is safe to say that a successful attack on criminal activity in Iraq is as important in determining the country's future as the outcome of the current anti-

insurgency campaign. One might even venture to say they are largely one and the same.

Organized Crime, Iraqi-Style

INSIDIOUS CRIMINAL activity is not new to Iraq. In fact, as recent revelations coming out of the UN's oil-for-food scandal reveal, criminal activity has long been pervasive in all areas of Iraqi society from the highest levels of official power to the lowly smuggler trying to eke out an existence during the period of sanctions in the 1990s. Under Saddam Iraq became what Iraqi sociologist Faleh Abdel Jabar calls the family-party state dominated by close family members and tribal associates.

In this environment, the Ba'athi regime became more an organized crime syndicate than a political organization. Those who ran the family-party state, having lost their political and economic prerogatives after the war, organized the initial uprising through exploiting the extensive infrastructure used for sanction busting under the old regime.

In time, looters, ex-convicts and nihilistic, jobless youths began coalescing into gangs, realizing that banding together gave them a collective power to mug, rob and otherwise get a Darwinian foothold in the local economy of a leaderless land. And at the same time, the tribes that dominate much of society outside

Robert Looney is professor of National Security Affairs at the Naval Postgraduate School in Monterey, California.

Report Documentation Page			Form Approved OMB No. 0704-0188					
<p>Public reporting burden for the collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Washington Headquarters Services, Directorate for Information Operations and Reports, 1215 Jefferson Davis Highway, Suite 1204, Arlington VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to a penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number.</p>								
1. REPORT DATE 2005	2. REPORT TYPE	3. DATES COVERED 00-00-2005 to 00-00-2005						
4. TITLE AND SUBTITLE The Business of Insurgency: The Expansion of Iraq's Shadow Economy			5a. CONTRACT NUMBER					
			5b. GRANT NUMBER					
			5c. PROGRAM ELEMENT NUMBER					
6. AUTHOR(S)			5d. PROJECT NUMBER					
			5e. TASK NUMBER					
			5f. WORK UNIT NUMBER					
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) Naval Postgraduate School,National Security Affairs,1 University Circle,Monterey,CA,93943			8. PERFORMING ORGANIZATION REPORT NUMBER					
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)			10. SPONSOR/MONITOR'S ACRONYM(S)					
			11. SPONSOR/MONITOR'S REPORT NUMBER(S)					
12. DISTRIBUTION/AVAILABILITY STATEMENT Approved for public release; distribution unlimited								
13. SUPPLEMENTARY NOTES								
14. ABSTRACT								
15. SUBJECT TERMS								
16. SECURITY CLASSIFICATION OF: <table border="1"> <tr> <td>a. REPORT unclassified</td> <td>b. ABSTRACT unclassified</td> <td>c. THIS PAGE unclassified</td> </tr> </table>			a. REPORT unclassified	b. ABSTRACT unclassified	c. THIS PAGE unclassified	17. LIMITATION OF ABSTRACT Same as Report (SAR)	18. NUMBER OF PAGES 6	19a. NAME OF RESPONSIBLE PERSON
a. REPORT unclassified	b. ABSTRACT unclassified	c. THIS PAGE unclassified						

of Baghdad include clans that specialize in thievery, and are trafficking in much of the artillery and heavier weapons left behind by the collapsed Iraqi army. Ironically, the sheer profitability of criminal activity in Iraq may be negating the effectiveness of standard political solutions to the insurgency such as increasing Sunni representation in the government or neutralizing foreign fighters.

With segments of the insurgency's financial needs matching or in some cases overriding its political motivations, an increasing amount of time and effort of these groups is devoted to creating "in house" criminal capabilities. This shift in insurgent activity demands greater anti-crime capabilities on the part of the Iraqi government. Unfortunately, the Iraqi police infrastructure suffered greatly from damage and looting in the aftermath of the war. Although significant progress has been made by the Coalition Provisional Authority (CPA) in rebuilding and reopening police stations, as well as in providing basic training and a limited amount of equipment, much more remains to be done, particularly in developing specialized capabilities to tackle organized crime and drug trafficking.

Complicating matters is the near impossibility of establishing effective anti-crime programs in an environment of rampant corruption. The prestigious Transparency International Corporation ranks Iraq as the most corrupt country in the Middle East. The country's current ranking is 129th out of 145 nations worldwide, with the country's corruption actually worsening between 2003 and 2004.

Instability, high unemployment and corruption have created a volatile mix ideal for organized crime. Police and border security capabilities are unlikely to be focused intensively on criminal activity, while the insurgency continues to disrupt police activities and divert resources. Even more ominous are signs of the development of a kleptocratic state

in Iraq where ruling elites' principal motive for entering the government is to rob the state of resources. In this environment, Western intelligence agencies are becoming increasingly worried about the systematic strengthening of ties between terrorists and organized crime.

The profit motive appears to be the driving force for many of the groups currently operating in the country. Resistance and organized crime groups such as Ba'athi underground groups, local resistance, *jihadis*, Al-Qaeda, Kurdish factions and radical Shi'a are competing for power in Iraq through looting and attacks on pipelines and petroleum plants. In turn, the economic components of their criminal acts, largely undertaken to fund their terrorist activities (many of the young foot soldiers of the insurgency are paid anywhere from \$100 to \$2,000 for various attacks) include black market arbitrage, smuggling and kidnappings for ransom.

The Gasoline Scam

DESPITE THE CPA's attempts at free market reforms, a substantial part of market transactions are still carried out at administratively determined and heavily distorted prices. Of particular interest in the current context is the price control system covering all major oil products such as gasoline, diesel fuel, kerosene, heating oil and cooking gas (propane). Yet, paradoxically for a country so rich in oil, toward the end of 2004 it became incredibly difficult for average Iraqis to buy the fuels they need. Despite rationing, queues at gasoline stations were often days long. Diesel for generators and kerosene for heaters were in short supply, leaving many parts of Baghdad in complete darkness.

Conspiracy theories abound: many believe the shortages are a form of punishment inflicted by the government. Another popular theory is that the shortages

stem from the Coalition forces plundering of Iraq's oil reserves. In actuality, most of the problem can be found by simply examining the country's petroleum distribution network. Carefully targeted insurgent attacks on pipelines and truck convoys have crippled Iraq's oil infrastructure and have largely isolated the capital. Oil wells have been shut in while pipelines are repaired; oil derivatives sit in storage tanks in Umm Qasr while truckers spurn the long, dangerous drive to Baghdad.

There is plenty of blame to go around. Oil Minister Thamir Al-Ghadban summed up the present situation by noting: "We do not have a fuel crisis as much as we have a crisis of honesty." In a speech to Iraq's interim parliament, Deputy Prime Minister Barham Salih blamed "sabotage" of the country's main pipelines and "administrative corruption." An energy source in the capital said insurgents had managed to hit pipelines bringing fuel to Baghdad's main refinery as well as the distribution grid for refined products. However, an inspector for the capital's oil distribution company said the crisis was "manufactured" rather than real—storage depots were full, but oil ministry officials and station owners were collaborating in selling wholesale to smugglers.

An economic explanation for much of the crisis starts with the fact that the insurgent attacks have created a possibility whereby unscrupulous Iraqi officials and oil traders together with organized criminals have the opportunity to make huge profits buying gasoline at the official price, and then selling it on the black market. According to an Oil Ministry report leaked to the Baghdad paper *Al-Furat*, a gas station owner selling a tanker-load of gasoline at the official price could expect to make about \$340 in profit while selling the same gas on the black market would net more than \$4,800.

The government has already begun to clamp down on those officials and gas

station owners who are allowing the gasoline to leak into the black market. The distribution director in Al-Amarah (south of Baghdad) has been arrested for selling most of the governorate's gasoline on the black market, three managing directors in the Oil Ministry have been suspended and several government-owned gas stations closed pending investigation.

However, the insurgents continue to thrive, largely outside the government's reach. They control many of the distribution routes in the country. Leveraging this advantage they have been able to profit from the differential between the official, subsidized price and the international market price for gasoline by smuggling the fuel out of the country. This not only allows insurgents to raise huge amounts of money to fund their operations, but also helps them to inflame popular opposition to the occupation. To add insult to injury, the insurgents often simply sell, through various front organizations, the gasoline back to the government to begin another cycle.

While no hard data exists on the profits earned by the insurgency through black market arbitrage, a safe guess is that it is likely to be in the high millions. The cost to the government stemming from providing subsidized gasoline amounts to \$5 billion in lost revenues, or about \$200 per Iraqi. The effect on the country's stability is two-pronged. With rising reconstruction and security costs, the government's ability to fight the insurgency declines at the same time effectively subsidizing insurgent activities. Outright theft and smuggling compound the losses to the country stemming from black market arbitrage. CPA officials estimated in early 2004 that smugglers were able to steal up to \$200,000 worth of oil a day.

Unfortunately for the government very few solutions to the problem present themselves. Increasing the price of oil derivatives would remove the price differential and prevent insurgents from

profiteering at the expense of the average Iraqi—but unfortunately the average Iraqi is likely to interpret any price increase as the government profiteering at his expense. Clamping down on the officials who are selling the products onto the black market should help, but when corruption has become so pervasive it is difficult to imagine that the government will ever be able to stem the tide entirely.

The Kidnapping Industry

KIDNAPPINGS HAVE become an institutionalized criminal activity in Iraq. The Iraqi Police Service reports that under Saddam Hussein abductions made up 1 percent of their cases, but they now account for 70 percent of reported crime. In early 2004, on average two people were kidnapped every day in Baghdad, with a typical ransom of about \$25,000. Both figures have steadily increased with the development of sophisticated kidnapping gangs—at the end of the year the average had risen to 10 kidnappings per day.

While the kidnapping of foreigners receives most of the publicity, hundreds of wealthy Iraqis, especially Iraqi women, have also fallen into the clutches of the kidnapping gangs. The gangs appear to be made up of criminals, unemployed soldiers and former *mukhabarat* agents with little to lose and much to gain in Iraq's security vacuum. Some go straight to the hostage's family or employers demanding a ransom; others feel that they can achieve a more satisfactory price selling their hostages to militant groups. The highest bidders for foreign hostages are likely to be organizations with a political axe to grind, looking for leverage over foreign governments.

In short, common criminals are working in tandem with insurgents, and the political demands of groups that execute captives in the name of their causes are driving a street-level hostage economy.

The two groups appear to be feeding off each other in a variety of ways. Insurgent groups "outsource" the seizures to criminal gangs for money, and gangs independently take hostages when the opportunity arises and then sell them up the chain to the insurgent groups.

Kidnapping is an especially attractive business for the insurgents. It is not only an easy source of revenue to help fund their operations, the activity supports their cause in a more subtle, wide ranging way. It helps to feed popular dissatisfaction both with the government, which appears to be unable to control the country, and with the Americans, perceived as unable to provide effective security.

The economic consequences of terrorist-related criminal activities have been devastating for the development of the economy. By targeting businessmen and professionals such as doctors and university professors, the insurgents have sparked an exodus of Iraq's "human capital"—depleting the key building blocks of the country's formal economy. With little or no growth in the economy, the expansion of the shadow economy is coming directly at the expense of the productive elements needed to rebuild the economy.

The Drug Trade

UNTIL RECENTLY, drug trafficking was not viewed as a serious problem. But given Iraq's porous borders, geographical location—situated near one of the major drug routes for opiates from Afghanistan—and an established tradition of smuggling, it is set to rise. Heroin, hashish and prescription drug smuggling from Afghanistan, Iran and Syria is making a comeback through transit points such as Samawah—the closest town to the Saudi Arabian border—after being interrupted by a 2000–01 crackdown by Saddam and the subsequent U.S.-led war to oust him.

Drug smuggling proceeds along two

main routes—along a northern route from Iran to Turkey and from there into the Balkans pipeline for distribution in western Europe and a southern route to the Iraqi port of Umm Qasr where it transits alongside illegally tapped oil and looted copper into the Gulf states. Other drug shipments move across the long, unguarded Saudi-Iraqi border.

The inflow of drugs into Iraq is associated with the significant increase in Iranian pilgrims visiting Shi'a shrines in Najaf and Karbala. The CPA estimated that 10-15,000 Iranians enter Iraq each day, a development that has naturally encouraged Iranian drug smugglers to begin using the pilgrim route as a transhipment artery. Since September 2003 a number of Iranian pilgrims have been apprehended with large consignments of drugs, principally hashish.

Most experts concede that the drug trade in Iraq is increasing. In 2004 the border police seized 323 pounds of drugs, mostly hashish and opium coming in from Iran. The United Nations' International Narcotics Control Board has expressed concern over Iraq emerging as a narcotics route. While numerous incidents have been cited by the Board, perhaps the most disturbing came in late May 2005 when six Iranians arrested in Sulaymaniyah were arrested with a large stash of narcotics and explosive materials.

The extent to which the insurgency is benefiting financially or materially from the drug trade is unclear at this time. It is a fact, however, that under Saddam, Iraq's intelligence services (now key participants in the insurgency) were complicit in drug smuggling.

Money Laundering

THE VARIOUS illegal markets noted above intersect in the *hawala*-based money laundering market. In its simplest terms, the *hawala* system works as follows: an

individual desiring to transfer money exchanges cash for a *hawala* note, often coded or secretly marked to foil potential counterfeiters. This note is then transferred to the other party via mail or courier, who in turn presents the note to an associated exchanger in their country, who converts the *hawala* note back into the appropriate cash specified in the note, minus a handling fee. In modern times, the use of e-mail, faxes, and telephones have made these private cash transfers almost instantaneous and nearly impossible to trace or regulate.

The attractiveness of the *hawala* system to terrorists and criminals is obvious. As with most criminal activities in Iraq, the *hawala* system was given a great stimulus by the sanctions in the 1990s. The sanctions made it impossible for Iraqis outside the country to legally transfer money to friends and relatives in Iraq. Using this system, informal money-brokers took money in the United States and other countries and got contacts in Iraq to deliver the equivalent (minus a fee) to recipients in Iraq. Other methods included taking cash in person—always risky—or depositing money in a bank in Jordan or Turkey and hiring couriers to take it into Iraq, through Iraqi Kurdistan in the latter case.

At the present time, little is known of the *hawala* network in Iraq. This stems in part from the fact that the system is essentially an unrecorded, informal arrangement based on trust rather than reliance on formal records of financial transactions. While data on *hawala* activities are nearly non-existent, there are signs of its importance. Zarqawi activists in Dublin, Ireland, for example, are believed to have moved money to Iraq using the *hawala* system.

The dilemma for the Iraqi government posed by *hawalas* is that while there is clear abuse of the system by Zarqawi and other criminal elements, the vast majority of money transferred by an individ-

ual *hawaldar* is likely to have come from legal, legitimate sources. A crackdown by authorities at this time might cripple many legitimate transactions that, in the absence of a viable domestic banking system, serve a valuable economic function. Further, as an amorphous collection of independent operators, the *hawala* system does not depend on a single location of infrastructure. A crackdown would simply drive them underground. No doubt at this point such a crackdown would further alienate many Iraqis who would view the action as caving in to Western demands at the expense of Muslim tradition. Even the CPA was reluctant, in its many orders setting regulatory standards for the country's financial system, to venture into this area. In particular, even its "order #93" covering money laundering was largely silent on *hawala* transfers. Understandably Iraqi politicians have been reluctant to suggest any form of *hawala* regulation, even along the successful lines pursued by the UAE.

That leaves two ways to deal with this system—intelligence or structural macroeconomic change. The latter is more effective and implies creating an economic climate in which people switch to a formal banking system. At the present time, however, the *hawala* system is likely to be attractive to many Iraqis because it is less expensive, swifter, more reliable, more convenient and less bureaucratic than the formal financial sector. In Iraq's case the misuse of the formal banks by the old regime resulted in lost trust and confidence of large segments of the population. Bank robberies undertaken by the insurgents and criminal gangs have also lead many potential depositors to avoid the formal banking system.

In part these factors have resulted in little postwar progress made in developing viable alternatives to the range of informal banking relationships that exist in the country. The semi-official Iraqi Strategic Review Board has acknowl-

edged that Iraq's financial sector still has extremely low capacity and capitalization, with poor credit facilities and a weak system of money transfers. It estimates that the banking sector has only \$2 billion in assets, spread among the central Bank, six public banks and 18 private ones. Overall, the banking sector is only playing a marginal role in the economy as a provider or absorber of liquidity.

The impact of the insurgents and criminal elements in Iraq may have significant consequences beyond their direct actions. By creating an unstable security situation, while at the same time increasing the profitability of the *hawala* system, their actions are retarding the development of the formal banking system.

THE CURRENT wave of crime and insurgent activity create and are in turn supported by an increasingly sophisticated criminal economy. Despite the many problems, there are encouraging signs that progress is being made against the insurgency.

The key is to get economic growth moving, allowing the authorities the breathing space to jump-start the reform process. If the lessening of insurgency activity allows the often-postponed massive infrastructure reconstruction projects to finally begin, this would have a major impact on the economy. As the shadow economy contracts, increased transparency makes official corruption more difficult. Losing its political accommodations, a crime-based insurgency would lessen, as more Iraqis would have a real stake in moving the reform process along.

There is another, less pleasant alternative. Even if the insurgency lessens, if unemployment remains high, then the shadow economy and the criminal infrastructure that nourishes it would continue to grow. So, we neglect the economic roots of the Iraqi insurgency at our peril. □